

Monetary Developments in Italy from 1961 to 1965

1. A large amount of liquidity was created in Italy during 1958 and the first half of 1959 (1) as a result of the simultaneous increase in the balance-of-payments surplus and in the Treasury cash deficit. It stagnated in the banking system owing to the weak demand for credit.

Demand for credit revived during the summer of 1959, with the start of a phase of vigorously expanding production and foreign trade that continued until nearly the end of 1961. During this phase economic advance became so fast that the downturn of 1958 was offset and activity levels rose back to the trend line of the previous decade. The expansion of credit even exceeded that of industrial activity. The price decline which had been a feature of 1958 and the first half of 1959 came to an end, but up to the autumn of 1961 the price level remained stable, thanks partly to the persistent weakness of basic products on world markets.

The association of expansion with stability became thus more striking towards the end of the 14 year period 1948-1961, which was characterized as a whole by such happy concurrence. This rare, and in the case of Italy previously unknown, development gave rise between the middle of 1959 and the end of 1961 to the image of the "economic miracle". Against a background of income growth and price stability (2), it involved the untrammelled play of clearly

(1) "Monetary Stability and Economic Development in Italy, 1946-1960", *Banca Nazionale del Lavoro Quarterly Review*, No. 56, March 1961.

(2) The part played in the Italian economic system by such transfers and by economies of scale in increasing average productivity is confirmed in penetrating investigations by AUGUSTO GRAZIANI, *Sviluppo del Mezzogiorno e produttività delle risorse*, Edizioni scientifiche italiane, Naples, 1964, and PAOLO SYLOS LABINI, *Prezzi salari profitti e produttività in Italia dal 1951 al 1964*, Consiglio nazionale delle ricerche, Rome, 1965.

interconnected factors — the balance-of-payments surplus, the reduction in the Treasury deficit, and the transfer of labour from low-productivity sectors and areas to manufacturing industry and urban districts in the more developed regions.

As economic expansion proceeded, the combination of factors affecting the supply of credit departed from the pattern characteristic of stagnation phases and became more similar to the one prevailing in times of recovery.

Italian postwar experience offers repeated examples of economic expansion combined with inflationary tensions. Such a situation prevailed from May 1946 to September 1947, from July 1950 to June 1951, and from the summer of 1952 to the spring of 1953, namely at the start of the long expansionary process that lasted till 1957.

From a study of these periods, as well as of those of stagnation or slower expansion which preceded them, it appears, typically, that phases of weak domestic demand bring about excess liquidity creation in the banks and for the economy as a whole (3). This is usually the case because less funds are put into active circulation; because the balance of payments improves; often because the budget deficit increases, too. By contrast, when the balance of payments deteriorates and business activity increases, the surplus liquidity is absorbed and the creation of additional liquidity then stems from internal sources, that is, from recourse to central-bank credit and from the ever-present excess of Treasury payments (relative to the tax revenue and to the growth of medium and long-term indebtedness).

2. The alternating pattern of the various sources of liquidity during recent years is shown in Table 1, covering the six years from October 1959 to September 1965, which are divided into four intervals of 18 months each. This division into periods of equal length fits in reasonably well with the timing of the most significant changes in liquidity flows and at the same time it facilitates an inter-period comparison of these changes (4).

(3) Reference is made to my three essays in monetary analysis which are included in the volume *Studi sulla moneta*, Giuffrè, Milan, 1965. The volume also contains the Italian version of the present essay.

(4) A detailed study of "liquidity creation" in the period 1958-1964 is found in the valuable paper by MARIO SARGINELLI, under that title, included in the *Lecture di politica monetaria e finanziaria* published by the Banca Popolare di Milano, 1965.

The presentation of the material in the table has been simplified compared with that in the Bank of Italy's *Report*, which gives more extensive and precise information. The latter follows a methodology elaborated principally by Dr. Ercolani and described in the Bank of Italy's *Bollettino* for January-February 1965.

In particular, the Report divides liquidity creation by the Treasury into two elements: (a) budget deficit and loans of the Central Post Office Savings Fund and (b) public debt operations. In the simplified version presented here, the net result of (a) and (b) is given.

In addition, the Report treats the whole of postal savings (including interest-bearing certificates) as a creation of liquidity which, because it is "absorbed" by the public, does not increase bank liquidity. In showing how the changes in the latter were generated (Table 1) postal savings have therefore been excluded from both creation and absorption of liquidity. The table reflects, of course, among the central bank-Treasury transactions which create or destroy bank liquidity, the impact of the deposits and loans of the postal savings system on the Treasury's current-account with the Bank of Italy.

3. The table shows that in the first two periods, i.e. in the three years from October 1959 to September 1962, the considerable expansion of economic activity was not accompanied (up to about the middle of 1962) by any appreciable deterioration in the balance of payments.

The liquidity effect of the external payments surplus was reduced in the first period (October 1959 to March 1961) by means of allocations of foreign exchange against lire made to the banks from official reserves. They were to be used, according to the directives of the exchange control authorities, first to cut down net indebtedness abroad (which had been stimulated in 1958-1959 by low international interest rates and by competition between the banks to secure the best customers by offering funds at those rates), then to balance the net debit position abroad. To finance these foreign exchange purchases, concurrently with the draining-off of liquidity occasioned by the growth in the currency and the compulsory reserves against deposits, the banks had to reduce substantially their holdings of Treasury bills, thus increasing correspondingly Treasury borrowing at the central bank.

During the second period, incipient wage inflation caused the net issue of notes to double. Bank money also expanded more rapidly, but liquidity absorption in the compulsory reserves was

TABLE I
FACTORS CONTRIBUTING TO THE CHANGE OF BANK LIQUIDITY, OCTOBER 1959 - SEPTEMBER 1965
(in milliards of lire)

| 18 month periods | Liquidity created by the Bank of Italy | | | Potential liquidity creation by means of credit lines extended by, or claims on, | | | Actual and potential creation | Absorption | | | Change in bank liquidity | | | |
|----------------------|---|--|------------------------------|--|-----------------------|--------------|-------------------------------|-------------------|------------------|------------------|--------------------------|---------------------|--------------------|--------------------|
| | through the increase in official reserves (a) | through operations with the Treasury (b) | through credits to the banks | Total | the Rest of the World | the Treasury | | the Bank of Italy | Total | Currency (c) | | Compulsory reserves | Total | |
| | (1) | (2) | (3) | (4) | (5) = (1) to (4) | (6) | (7) | (8) | (9) = (6) to (8) | (10) = (5) + (9) | (11) | (12) | (13) = (11) + (12) | (14) = (10) - (13) |
| October 1959 - | | | | | | | | | | | | | | |
| March 1961 . . . | 304 | -233 | 580 | 53 | 704 | 55 | -410 | -7 | -362 | 342 | 254 | 447 | 701 | -359 |
| April 1961 - | | | | | | | | | | | | | | |
| September 1962 . . . | 560 | - | 119 | 205 | 884 | 79 | -118 | 69 | 30 | 914 | 527 | 346 | 873 | 41 |
| October 1962 - | | | | | | | | | | | | | | |
| March 1964 . . . | -1,160 | 597 | 1,059 | 644 | 1,140 | -124 | -203 | -59 | -386 | 754 | 548 | 497 | 1,045 | -291 |
| April 1964 - | | | | | | | | | | | | | | |
| September 1965 . . . | 1,572 | -636 | 719 | -683 | 972 | 334 | 250 | 278 | 862 | 1,834 | 320 | 598 | 918 | 916 |

(a) Column (2) shows the change due to Italian banks' short-term indebtedness abroad; column (1) that due to the other items of the balance of payments.

(b) Including the compulsory bank reserves invested in securities.

(c) Bank of Italy note circulation net of the banks' cash holdings.

reduced by a measure that lowered, from 25 to 22.5 per cent, the maximum reserve to be held against deposits. This measure, introduced in January 1962, freed 200 milliard lire of "high-powered" liquidity. In spite of this, bank holdings of Treasury bills continued to decrease, though at a slower rate, and there was increased recourse (to the amount of 152 milliard lire) to the central bank and to the Italian Exchange Office, whose assistance took the new form of depositing with the banks foreign exchange drawn from official reserves. Bank liquidity, which in the preceding period had fallen by 359 milliard, rose by 41 milliard.

The liquidity created by the reduction in compulsory reserves and by the banks' wide recourse to the credit of the central bank and the Italian Exchange Office was further increased by the re-issuing of only part of the 9 year Treasury bonds maturing at the beginning of 1962. The non-renewal of 104 out of 286 milliard worth of bonds falling due aimed at containing the amount of borrowing by the Treasury on the capital market at a time of tension in interest rates due both to the strain on domestic liquidity and to the Government's economic programme. From February 1962, it may be recalled, this programme received the approval of part of the left-wing political forces, for it included the nationalization of the electricity industry, the withholding tax on dividends and a town-planning bill directed also against private gain from increases in building and building-site values.

During this second period the behaviour of the monetary authorities therefore became moderately expansionary, influenced as it was by the large, progressive accumulation of foreign exchange reserves that had begun in 1958, by the promptings of international bodies, and by the sheer importance of domestic problems capable of being eased and solved on the wave of economic prosperity.

4. This orientation became more distinct in the third period, namely the one from October 1962 to March 1964. In face of a substantial worsening of the balance of payments, which had begun in mid-1962, in October the banks were again authorized to maintain net debit balances abroad. In the deposits (in cash and Treasury bills) formed to guarantee the issue of *assegni circolari* (cashier's cheques), the banks were authorized to include mortgage bonds and other long-dated securities, the effect being to free liquidity equi-

valent at the time to more than 100 milliard lire. In January 1963 total redemption was arranged of the 9 year Treasury bonds falling due, for an amount of 192 milliard lire. In this period, too, greater efforts were made to place medium and long-term securities, particularly those issued on behalf of the Government to finance the "Green Plan" for agriculture, the railways and the National Electricity Board, with the Central Post Office Savings Fund and the banking system.

The aim of allowing investment under way to be completed and put into operation, as well as the other reasons that led the Government to adopt this policy, have been outlined in official documents.

The policy itself was consonant with the line which central banks seem to have generally followed in the past, notwithstanding the *rules of the game*; namely, to counterbalance instead of strengthening the impact of external surpluses and deficits on the volume of credit, and even to slow down the development of internal re-equilibrating processes of a deflationary character, while stimulating those of an expansionary nature.

The developments of 1962-1963 may perhaps be brought into a clearer focus by comparing them with those occurring in the inflationary revival of 1946-1947.

The resumption of inflation in 1946 was preceded by the introduction of the sliding scale for wage-earners (during the first half of 1945) and the granting of strong wage increases immediately after the Liberation. Cost inflation created a high demand for bank credit, since expenditure on wages constantly tended to exceed turnover.

Adjustment to cost inflation then took place through a progressive rise in prices, the effect of which on export profits was offset, for the main trading relationships, by successive adjustments of the exchange rate, which rose in terms of the dollar from 100 in January 1946 to 575 in November 1947. The effect on imports was regulated not only by exchange policy but also by government imports connected with aid programmes and by licensing procedures (particularly as regards textile raw materials).

In all these respects the situation by 1962-1963, compared with the early postwar years, had undergone deep changes.

With the abandonment by developed countries of the practice of multiple exchange rates, and of quantitative restrictions on imports, any exchange depreciation would have had an adverse impact

on the whole range of imports, which had greatly increased in terms of GNP. In turn, their higher cost would have set in motion the sliding scale mechanisms, which had become more sensitive and widespread than those applying during the first postwar years.

Early in 1962 profit margins were still large, and, although they were being whittled down, exports were sustained at a high level. Only in the final stage of the boom did the pressure of domestic demand begin to affect exports perceptibly. On the import side, the effects of excess demand were greater. Between 1961 and 1963 imports of goods and services rose in value terms by 45 per cent, whereas exports went up by no more than 24 per cent. The value ratio of exports (goods and services) to imports fell from 1.04 in 1961 to 0.89 in 1963. On the basis of customs data, the ratio of exports to c.i.f. imports fell from 0.87 in 1959 to 0.80 in 1961 and 0.67 in 1963.

The developments of the period October 1962-March 1964, as shaped by policy decisions, are reflected in the data given in the third line of the table. As a result of the reduction in official foreign exchange holdings, liquidity contracted by 563 milliard lire — a figure that would have been nearly twice as large (1,160 milliard) had the banks not incurred net debts abroad of 597 milliard (5). The increase in the currency issue continued during the period at the same high rate as before. The expansion of compulsory reserves against deposits was substantially greater, since no major measures were introduced to lower the compulsory ratio, such as the one of January 1962, but only minor modifications.

The banks met the liquidity drain resulting from the three factors just listed largely by borrowing from the central bank, by mobilizing residual holdings of Treasury bills and by reducing their foreign currency balances (6).

(5) During certain periods (i.e. in the last quarter of 1962 and again in the summer of 1963) the increase in bank indebtedness abroad exceeded the deficit in the other items of the balance of payments, so that the official reserves increased.

(6) In Table 1 the changes in the position of the Italian banks vis-à-vis foreign banks are reflected in the following movements.

The funds borrowed from foreign banks increase the official foreign exchange reserves and create liquidity in lire (column 2) when they are sold to the Italian Exchange Office.

The foreign exchange purchased against lire by the banks from the Italian Exchange Office can be (a) used for repayment of foreign bank loans, (b) deposited (or used in credit operations) abroad. In case (a) there is only a destruction of liquidity in lire (column 2); in

But liquidity was mainly fed by the Treasury's very considerable use of central bank credit, which can be regarded as the balancing item, i.e. the net result of (a) the budget deficit, excluding public debt operations, (b) medium and long-term public debt operations, and (c) the change in the floating debt. Usually items (b) and (c) help to reduce the size of this balancing item. But during the 18 months under review the Treasury's general line of policy led it to restrict its short-term borrowing from the banks and the Central Post Office Savings Fund, in order to allow these financial intermediaries to channel a larger flow of funds to investment in medium and long-term securities. By not refunding a large 9 year bond issue which matured in January 1963, the Treasury also curtailed its direct recourse to the capital market. Consequently the transactions under (b) and (c) had the effect of increasing the Treasury's borrowing from the central bank.

While details can be obtained from the quarterly analyses in the Bank of Italy's Report and *Bollettino*, an overall confirmation is provided by the following data for the three largest items of the public debt (in milliards of lire):

| | September 1962 | March 1964 | Change |
|--|----------------|------------|--------|
| Treasury bills | 2,012 | 1,867 | —145 |
| Debt to the Central Post Office Savings Fund | 1,372 | 1,247 | —125 |
| Medium and long-term securities | 2,247 | 2,128 | —119 |

5. The Treasury's actions were in conformity with the wider operating aim of the monetary authorities to support the demand for (and therefore the prices of) medium and long-term securities, both by limiting government demand on the capital market and by channelling to the market a larger share of funds received by the banks and the Central Post Office Savings Fund.

During this period, as self-financing by firms began to shrink, the ratio of fixed assets to long-term funds (owned and borrowed)

case (b) there is, in addition, an equivalent liquidity creation in foreign currency (column 6); therefore the behaviour under (b) is neutral as regards bank liquidity.

The effect described under (b) is similar to the one following a reduction of banks' debt on advances account with the Bank of Italy: receipt of lire by the central bank destroys liquidity (column 4), but the consequent increase in the unutilized margins available on advances account creates an equal amount of it (column 8).

rose, and firms started to rely increasingly on short-term sources. Accordingly, a shift occurred in the composition of bank assets towards longer-term, higher yield credits and securities.

As to the implications of these changes, the following points seem worthy of consideration.

To the extent that bank assets reflect the financing of working capital, the market not only offers the individual bank different mechanisms for adapting its loans to changes in the volume and structure of its total deposits, but provides the banking system as a whole with many opportunities for adjusting the volume of credit to changes in the credit base arising from official policy actions. When the average liquidity situation becomes strained, customers shift to institutions where credit is relatively less tight, for example, from the larger to the smaller banks and the savings banks. At the same time, there are also cases of bank credit being replaced by trade credit granted by large firms, which become suppliers of funds by using lines of bank credit they possess but have not previously drawn upon. A credit potential is therefore realized by both the credit givers and the borrowers of funds.

At this stage, partly as a result of lower interest rates, recourse to borrowing abroad comes into play: by banks through direct short-term credit transactions, by importers and exporters through changes in the terms of payment (which will be shortened for exports and lengthened for imports). The growing importance of leading corporations which are members of, or associated with, international groups, especially in sectors such as oil, represents a new source of foreign funds; as the relative tightness of individual money markets changes, these firms act so as to reduce the degree of credit stringency in any single country by moving into it cash resources, either owned or borrowed elsewhere (except when changes in exchange rates are expected).

Taking both self-financing and credit, these adjustments ultimately entail some net reduction in the availability of funds for, and hence in the volume of, fixed investment (for example, in the case of supplier firms that are called upon to help customers by granting credit). The extent of the reduction will be governed by the economic advantages offered by the entire network of credit relationships.

To the extent that fixed investment is financed by bank credit, the possibilities of shifting to new credit sources seem to be reduced. For it will be less easy to rely on assistance from suppliers who

provide creditworthy firms with real working capital (goods that exhaust their usefulness in a single productive cycle) and therefore, within the limits of what they supply, are ready to accept the risk of helping their customers with their own credit. Under these circumstances, the possibility for businessmen engaged in foreign trade to use foreign commercial banks as an alternative source of credit is negligible, while the creditworthiness of the domestic banks on the international market is also reduced as a result of the lower liquidity structure of their assets.

Similarly, when the banks expand their investment in securities instead of granting short-term loans, the area where the demand for credit adjusts itself to the supply (hence to liquidity) is concentrated in the capital market, with more specific effects on the availability of funds for new investment, on long-term interest rates and therefore on the value of the sum total of financial assets existing in the economy.

When all is said and done, it does not seem rash to conclude that the existence of a large sector of commercial banks, which acquire short-term funds and use them in extending credit for working capital, especially when they collaborate with foreign banking systems organized on similar lines, ensures that the adjustment process is spread over a far larger field of business relations, thus obtaining wide and better distributed effects over time; that is, judged in relation to the objectives of stability and growth, the process follows more rational paths.

6. Chart 1 illustrates the movement of several indicators from the beginning of 1962 to the summer of 1965.

All the series shown are in money terms, except for GNP, which is at constant prices. The series on "Banks' use of central bank credit" and on "Treasury cash requirements" represent 12-month flows, at quarterly intervals. The data on "Balance-of-payments surplus or deficit on goods and services" relate to the quarter-year and are seasonally adjusted.

The picture it gives of the period (October 1962-March 1964) covered in the two previous sections is roughly the following.

The rate of expansion of GNP, in real terms, declined throughout 1962 and levelled off at the beginning of 1963. That of

CHART 1 a

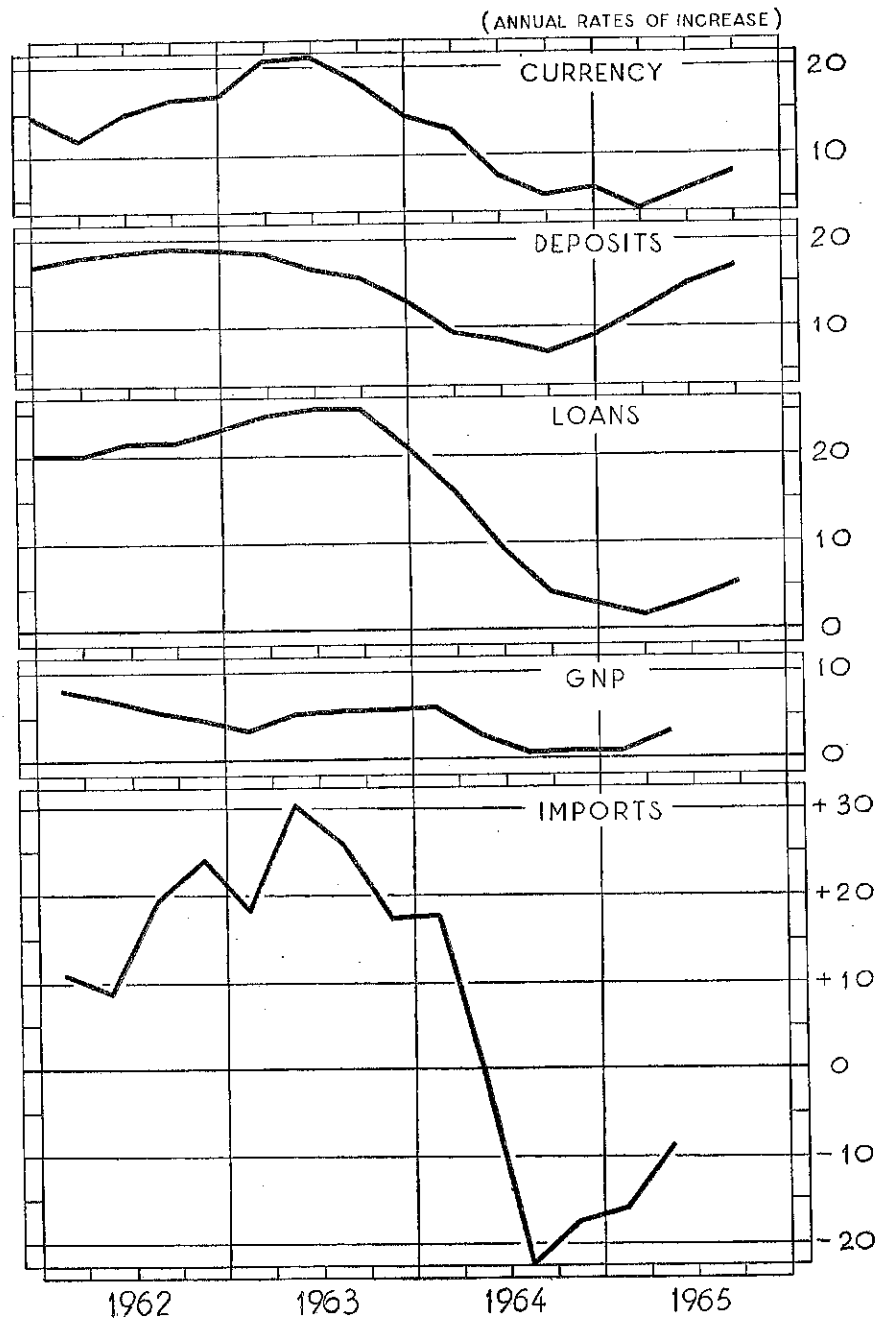


CHART 1 b

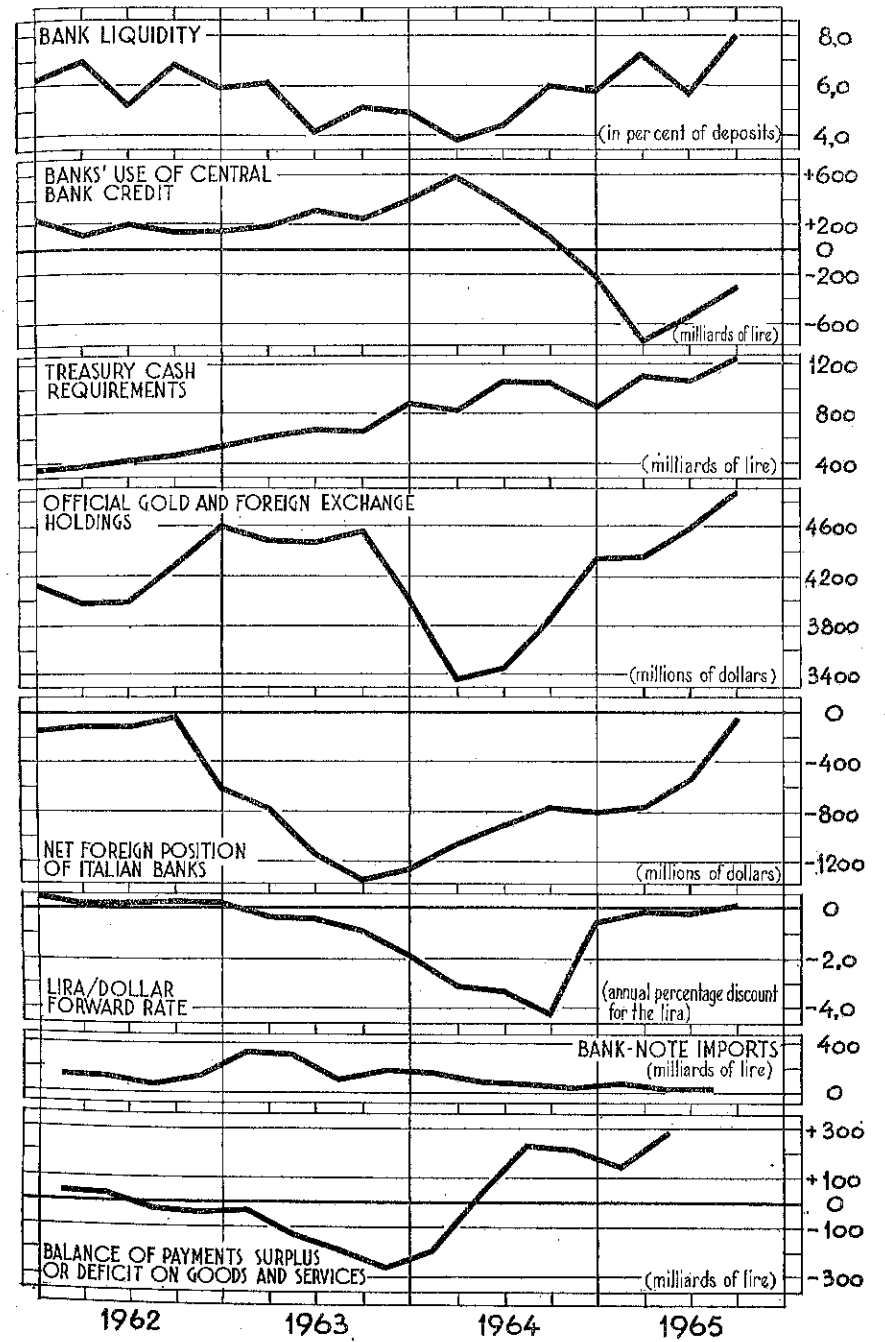
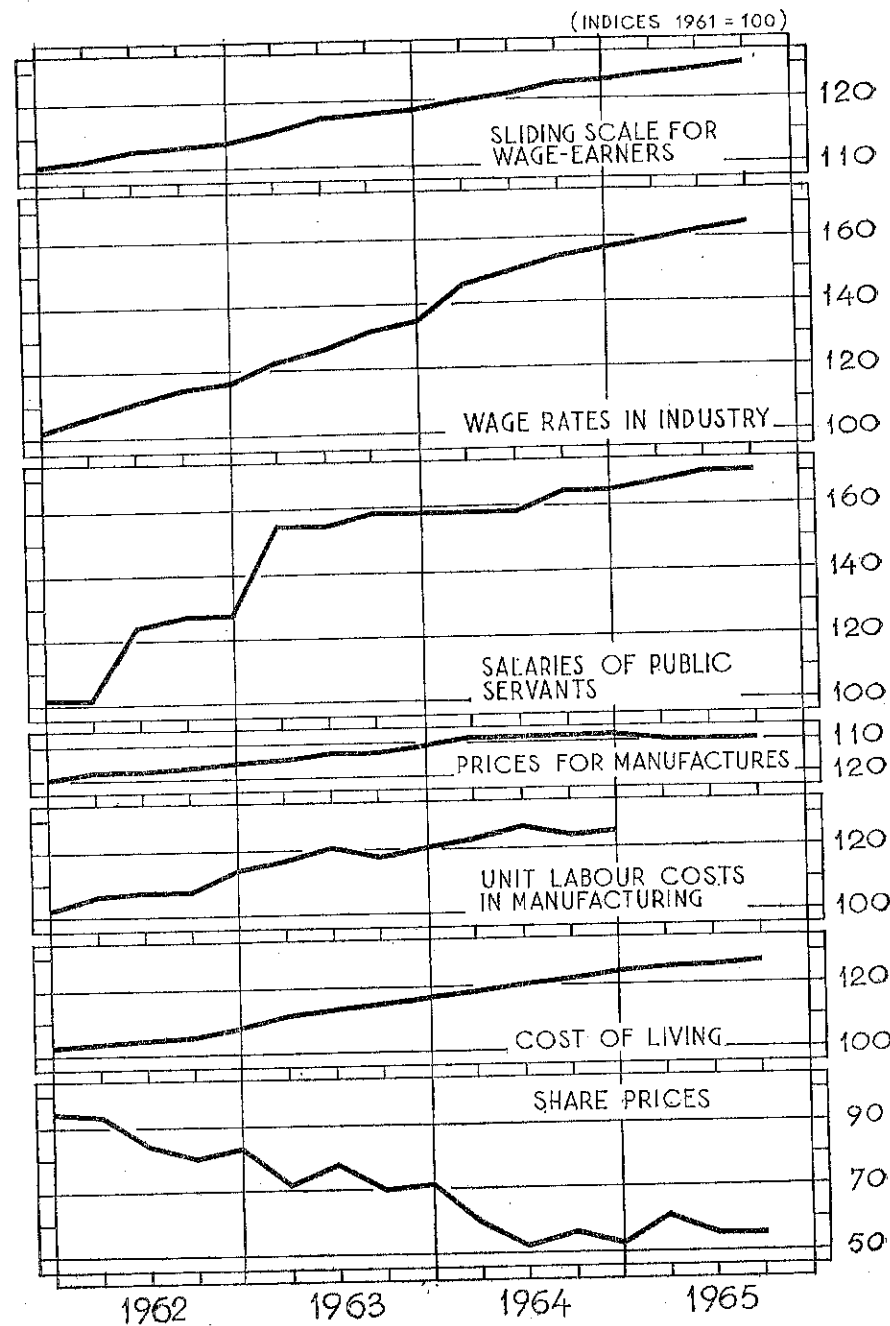


CHART 1 c



deposits, after reaching about 20 per cent annually in the second half of 1962, began to fall — sharply from March 1963 — and was halved within a year. The acceleration in the growth of currency persisted longer, going on up to the middle of 1963, when an annual rate of 20 per cent was exceeded. In this phase, therefore, the shift from deposits to notes, already seen both in the war years and in the 1946-1947 inflation, repeated itself, but it reflected in particular the acquisition by wage-earners of a growing share of the national income. The rate of growth of bank loans reached still higher peaks (25 per cent towards the middle of 1963) and the expansion continued until the autumn (Chart 1 a).

The various items which, with deposits, contribute to the formation of banks' liabilities, and with loans, to their assets, increased at different rates. This applies particularly to the liquid assets, which tended progressively to shrink, in spite of the previously mentioned ample liquidity created through the facilities granted by the Bank of Italy, as well as through the Treasury deficit and the recourse to borrowing abroad (Chart 1 b).

Credit expansion mainly financed the nominal component of income growth — a component that was swollen by rising wages. In the private sector the increases followed one another so rapidly as to form a continuous line, while in the public administration they came in irregular, massive lumps. The fall in profit margins — confirmed by comparing the rapidly rising trend of unit costs with the more restrained trend of prices of manufactures which was subject to pressure from foreign competition — contributed to the progressive fall in share prices (Chart 1 c).

In tables 2 and 3 an attempt is made to express quantitatively the deterioration in the monetary position in 1962-1964, compared with the one that prevailed before, and with the one that was established afterwards.

Table 2, following a scheme used by OECD, shows that the excess of total monetary demand over real supply, which had been moderate for many years (and was negative in 1959), increased fivefold from 1961 to 1962 and doubled again in 1963, when it rose to more than 10 per cent of GNP. Whereas in 1962 the excess was almost entirely absorbed by price increases, in the 1963 inflationary stage one-quarter of the gap was filled by higher net imports of goods and services.

Table 3 shows that the inflationary component of income expansion, which was nil in 1959 and barely equal to one fourth of

TABLE 2
TREND OF MONETARY DEMAND AND REAL SUPPLY, 1954-1964
(in milliards of lire)

| | 1954 | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| 1) GNP - previous year | 11,308 | 12,027 | 13,163 | 14,190 | 15,266 | 16,318 | 17,477 | 19,078 | 21,083 | 23,754 | 27,067 |
| 2) Overall demand (consumption + investment) | 12,272 | 13,396 | 14,440 | 15,453 | 16,189 | 17,173 | 19,072 | 20,972 | 23,805 | 27,715 | 29,397 |
| 3) Difference (2-1) | 964 | 1,369 | 1,277 | 1,263 | 923 | 855 | 1,595 | 1,894 | 2,722 | 3,961 | 2,330 |
| 4) Increase of GNP at previous year's prices | 538 | 833 | 566 | 917 | 644 | 1,322 | 1,271 | 1,646 | 1,408 | 1,204 | 807 |
| 5) Excess of overall monetary demand over real supply (3-4) | 426 | 536 | 711 | 346 | 279 | -467 | 324 | 248 | 1,514 | 2,757 | 1,523 |
| 5-a) Price increase | 181 | 303 | 461 | 159 | 408 | -163 | 330 | 359 | 1,263 | 2,109 | 1,728 |
| 5-b) Net imports (goods and services) | 245 | 233 | 250 | 187 | -129 | -304 | -6 | -111 | 51 | 648 | -205 |

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TABLE 3
TREND OF MONEY SUPPLY AND INCOME, 1958-1965
(percentage increases and ratios)

| Years | Increase in yearly average | | | Increase of GNP | | Increase in industrial output | Ratio to GNP (at current prices) | | | |
|----------|----------------------------|----------|----------|-----------------|------------------------|-------------------------------|----------------------------------|-----------------|-------------|-----------------|
| | Bank loans | Deposits | Currency | In real terms | Inflationary component | | of bank loans | | of currency | |
| | | | | | | | average | incremental (2) | average | incremental (2) |
| 1958 | 6.3 | 13.9 | 7.0 | 4.2 | 2.6 | 3.9 | 31.0 | 28.7 | 11.3 | 11.5 |
| 1959 | 9.5 | 17.1 | 9.2 | 8.1 | -0.9 | 11.5 | 31.7 | 41.6 | 11.6 | 14.7 |
| 1960 | 17.4 | 15.1 | 8.5 | 7.3 | 1.8 | 14.4 | 34.1 | 60.3 | 11.5 | 10.7 |
| 1961 | 20.5 | 15.7 | 10.6 | 8.6 | 1.7 | 9.5 | 37.2 | 66.8 | 11.5 | 11.6 |
| 1962 | 19.2 | 18.4 | 14.3 | 6.7 | 5.6 | 9.5 | 39.4 | 56.4 | 11.7 | 13.0 |
| 1963 | 24.2 | 16.3 | 18.5 | 5.1 | 8.4 | 8.2 | 42.9 | 68.5 | 12.1 | 15.5 |
| 1964 | 9.9 | 9.0 | 8.4 | 3.0 | 6.2 | 0.7 | 43.2 | 45.5 | 12.0 | 10.8 |
| 1965 (1) | 3.7 | 14.2 | 6.9 | 3.4 | 3.6 | 4.0 | 41.7 | 21.9 | 12.0 | 11.0 |

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(1) Estimate.
(2) Calculated between the increases in absolute value.

the real component in 1960 and 1961, was nearly as large as the latter in 1962, substantially exceeded it in 1963 and was overwhelmingly greater in 1964, when the real component rose but slightly.

7. The existing stresses and strains, viewed in terms of aggregate demand and external equilibrium (though not in terms of labour cost), were overcome in the six months from October 1963 to March 1964, which form a transition period to the situation that prevailed for the rest of 1964 and in 1965.

In September 1963 the central bank requested the banks not to increase further their foreign indebtedness. Consequently their liquidity, already under great strain, suffered during the subsequent six months the full restrictive impact of the persistent, large deficit in the balance of payments. Banks began to put a brake on loans (the annual rate of increase of which began to decline in September) and, up to March 1964, increased further their recourse to the central bank, so that about that time it reached the maximum recorded in this postwar period. In fact, credit for ordinary rediscounts and advances (plus day-to-day credits to clearing house members) stood in March 1964 at 982 milliard lire, about three-fifths (576 milliard) of which had been granted in the preceding 12 months.

This central bank's action, and the situation in which it was taken, show notable similarities with the September 1947 experience. By that time excess bank liquidity had been almost totally eroded and what remained was frozen through the introduction of compulsory reserves. In 1963, when the liquidity situation was similar, bank borrowing abroad was blocked so as to prevent it from rising further. In 1947, too, the central bank increased its assistance to the banking system after taking action to restrict liquidity creation.

In 1947, the central bank's restraining policy hastened the end of a process which, even had it not occurred, was bound to peter out later for lack of liquidity. Such action was mainly motivated by the fear that the process, if left to itself, might produce a foreign exchange crisis before absorbing the whole excess liquidity.

The phase of the economic cycle at the end of 1963 was not dissimilar: the inflationary process, although losing momentum, had rendered the economy vulnerable to a foreign payments crisis.

As a matter of fact, the lack of confidence shown in the lira, which led to exports of capital, became more acute in the first

quarter of 1964 (especially in March), when the current-account balance of payments was already approaching equilibrium. In that month Italy applied for and promptly obtained from international organizations and the United States credit lines for about one milliard dollars.

Together with the tight domestic liquidity situation, as well as other dampening factors emerging at the end of the boom, this assistance served to limit the flight from the lira. The lira's forward discount against the dollar fell in April and May. In June it temporarily rose again because of the Government crisis and the renewal of maturing forward sale contracts by speculators reluctant to close with a loss, though they had to do so in the autumn (Chart 1 b, forward discount curve).

The six-month transition period was therefore marked by an initial measure that closed off an important source of additional liquidity and by later action to mobilize financial resources abroad. In practice, there was no need to draw upon these resources, because confidence was quickly restored, encouraged in part by domestic restraint measures and by the progressive return to external equilibrium on current-account.

As to the domestic forces making for equilibrium, the comparison between 1946-1947 and 1962-1963 seems to establish itself along the following lines.

In 1946-1947, as already mentioned, equilibrium between costs and prices was maintained thanks to the increase of domestic prices, while equilibrium between the latter and international prices was restored from time to time, though not completely, by depreciation in the exchange rate. In these circumstances profit margins were not squeezed to such an extent as to bring business activity to a standstill; the limiting factor was rather the volume of liquidity available in the system or supplied by official sources.

In 1962-1963, on the other hand, firms were compelled to finance the rise in variable costs, above all for labour (as well as for taxes and interest on bank loans), by recourse to credit. Part of this additional income went to pay for net imports instead of flowing back to the firms, thus leaving them with receipts insufficient to cover their total costs.

Net imports stimulated activity abroad and depressed it at home, since in the absence of adequate profit margins and better prospects

firms cut down investment. The investment goods sector suffered a crisis. As the Bank of Italy's Report for 1964 (page 487) put it:

"The effects of the contraction of investment in industrial plant was aggravated by a fall in housing investment, with the result that the flow of income to these sectors lessened and with it their demand for consumer goods. Thus the impulse was propagated to the consumer goods industries, especially those making durables and semi-durables, where it depressed employment and income and more specially profit margins and, hence, again investment demand. This was the beginning of a downward spiral in which each turn generates the forces for the next one."

Therefore, one may conclude that an expansion vitiated by cost inflation, even when its end is not accelerated by lack of domestic liquidity and of foreign exchange, tends to work itself out because the income flow is diverted abroad.

This proposition will later on be reconsidered in the light of experience during the following period April 1964-September 1965.

8. Chart 1*a* shows that the annual rate of increase in bank deposits began to decline towards the middle of 1963 and continued to fall until it touched a minimum of 7 per cent in the third quarter of 1964. The successive recovery raised it to more than 15 per cent in September 1965. The growth in the currency issue, which, starting from higher values, began to decelerate later (about the middle of 1963), was brought down in September 1964 to 5 per cent, i.e. below the minimum expansion rate touched by deposits. On the other hand, the following upturn was slower; during this phase the pronounced shift of the previous inflationary phase from deposits to currency was accordingly reversed. The cyclical variability of bank loans once again proved itself greater than that of total deposits: their annual rate of expansion declined from the very high level (25 per cent) touched in the third quarter of 1963 almost to zero in the first quarter of 1965 and the ensuing recovery proceeded with difficulty. The peak reached by loans (third quarter of 1963) coincided with that for imports, the lowest point (March 1965) with that for GNP in real terms.

The gap left by the smaller expansion of loans compared with total deposits was filled by investment in securities and by the resto-

ration of bank liquidity, the creation of which was once again mainly due to the external surplus (Chart 1*b*).

As for the relative magnitude of the factors affecting liquidity we must return to Table 1.

The liquidity created as a result of the Bank of Italy's operations with the Treasury (719 milliard lire) was little higher than that applied by the banks to reduce their indebtedness with the Bank of Italy. Hence, liquidity creation shown in column 5 was almost entirely the counterpart of the 936 milliard lire of foreign exchange added to the official reserves. This increase derived from an external surplus of 1,572 milliard, 636 of which was earmarked for improving the net foreign position of Italian banks.

As observed in foot-note (6), to the extent that banks use up liquidity to reduce their advances from the Bank of Italy, they widen the margin available on advances accounts, which is treated as an element of their liquidity in column 8.

The improvement of their net foreign position took the form of an increase in assets (from 776 milliard lire in March 1964 to 1,312 milliard in September 1965) rather than of a reduction in liabilities (from 1,436 milliard to 1,336 milliard between the same dates). Since the assets in foreign exchange are treated (in column 6) as a component of liquidity, the improvement of the banks' foreign position, in so far as it took that form, did not affect bank liquidity.

When the banks are bound by directives from the central bank to maintain certain minimum ratios of foreign assets to liabilities, the former can no longer be treated *in toto* as a component of liquidity, because they partly take the character of a compulsory reserve. If in calculating bank liquidity this limitation were taken into account, then alongside the two absorption factors (currency and compulsory reserves for deposits) it would be necessary to enter a third factor, equivalent to the amount of foreign assets tied by the directive.

Since a directive of this kind applies at present (the banks having again been requested to balance their foreign position), the figure of 862 milliard lire entered in column 9 exceeds the amount of really available potential liquidity formed during the period.

The actual and potential liquidity creation is shown in the table as 1,834 milliard, though it comes out at a lower but nevertheless

impressive figure (about 1,500 milliard) when the above considerations are taken into account. Only half of it was absorbed by the expansion in compulsory reserves and currency. In the case of the latter, the growth rate fell again towards the 1960-1961 levels.

9. In section 7 it was emphasized that the deficit on the current items of the balance of payments (i.e. net imports of goods and services) diminishes the expenditure flow which is directed to domestic firms and tends to curtail the level of national output.

Nevertheless, business activity can be maintained if the expenditure flow is increased by one or both of the other possible sources — the liquidity deficit of the private sector (reflecting the use of liquidity previously set aside or recourse to bank credit) and that of the public sector (reflecting the financing of the Budget deficit by monetary means). On these assumptions, and as long as foreign exchange reserves and foreign credit are sufficient, a persistent external deficit is not incompatible with normal profit margins and therefore with high levels of output.

The experience of 1964-1965 shows that the opposite is also true. When labour costs are steadily rising (Chart 1 c), the net expenditure flow from abroad (i.e. the current-account surplus) does not necessarily create profit margins capable of reviving domestic production. Here two approaches are suggested to explain the coexistence for almost two years of an external surplus and low business profits.

(a) In a situation marked by normal profitability for business and balanced foreign accounts, producers of consumer goods receive, *inter alia*, an expenditure flow arising from incomes created by the investment goods sector, which they use for plant renewal. In the cyclical swing marked by sub-normal profits and low investment, this flow thins out. Part of the productive capacity of both sectors (consumer goods and investment goods) becomes available to meet external demand, and the economic system as a whole is able to achieve a surplus in export trade. The accumulation of foreign exchange then reflects the existence of depreciation quotas that have not been reinvested and finds a counterpart in the liquidity of the business sector (current accounts).

(b) Part of the income created in the private sector is saved by households: when it is channelled to investment by financial intermediaries, it flows back to the firms. In the absence of investment,

foreign demand replaces domestic demand. Foreign exchange accumulation then has a counterpart in the savings deposits of households.

In the long run, the formation of domestic liquidity due to increasing foreign exchange holdings will in both cases tend to lower interest rates and in this way stimulate investment. But the process is rather slow, partly as a result of institutional factors.

10. Throughout the whole of the five-year period under examination the Italian economy was marked by phases of powerful acceleration and deceleration in the rhythm of production and by very wide fluctuations in the aggregates most sensitive to general economic conditions, such as the volume of credit and investment, bank liquidity and the balance of payments.

Table 4 helps to provide a synthetic illustration of this departure from the orderly development of the fifties. A comparison of the last five years (1961-1965) with the previous eight (1953-1960) shows a fall of, as well as greater variability in, the rates of productive expansion; a more rapid growth of money wages; an unchanged rate of increase in, and a much higher coefficient of variation for, deposits and bank loans; a quicker and more irregular expansion of the currency.

The second part of the table illustrates the increased importance and higher relative variation of commercial bank borrowing at the central bank, as well as the contraction in bank liquidity. The greater variability of the latter during the first period was mainly due to the ample surplus in the balance of payments in 1958-1959 and to the associated creation of liquidity.

A satisfactory feature of the last 5-year period was the high ratio of investment to income, actually attributable to the first three years.

The inflationary component which accompanied growth widened from 1962 to the first half of 1964; then it contracted again, at the cost of a substantial reduction in the degree of utilization of productive capacity.

In my opinion, an economic policy that takes as its primary objective the restoration of a non-inflationary equilibrium at higher employment levels should encourage capital accumulation by all transactors (households, business and government); appropriate policy

TABLE 4

TREND AND VARIABILITY OF VARIOUS SERIES IN 1953-1960 AND 1961-1965

| Series | 100 × average value | | Coefficient of variation | |
|---|---------------------|---------|--------------------------|---------|
| | 1953-60 | 1961-65 | 1953-60 | 1961-65 |
| <i>Annual rates of growth:</i> | | | | |
| GNP at constant prices | 6.2 | 5.2 | 0.23 | 0.42 |
| Industrial output | 8.7 | 6.3 | 0.35 | 0.55 |
| GNP at current prices | 7.9 | 10.7 | 0.14 | 0.22 |
| Dependent labour incomes | 8.7 | 13.9 | 0.17 | 0.40 |
| Public servants incomes | 9.3 | 14.7 | 0.19 | 0.34 |
| Average hourly earnings of workers in industry | 4.4 | 12.1 | 0.33 | 0.33 |
| Bank loans | 15.0 | 15.4 | 0.34 | 0.49 |
| Bank deposits | 15.3 | 14.7 | 0.14 | 0.22 |
| Currency | 7.2 | 11.7 | 0.15 | 0.36 |
| <i>Ratios:</i> | | | | |
| Gross investment: GNP | 22.2 | 23.8 | 0.06 | 0.10 |
| Dependent labour incomes: national income | 54.4 | 60.5 | 0.02 | 0.06 |
| Dependent labour incomes in industry: value added | 49.7 | 54.5 | 0.01 | 0.06 |
| Bank loans: deposits | 74.4 | 75.4 | 0.04 | 0.04 |
| Banks' indebtedness with Bank of Italy: deposits | 4.5 | 5.1 | 0.17 | 0.28 |
| Bank liquidity: deposits | 10.1 | 6.2 | 0.20 | 0.15 |

actions in respect of the private sector should be matched by administrative firmness in the public sector (central Government, local authorities and public enterprises). It should be recognized, moreover, that some of the factors on which growth in the fifties was based have been losing momentum.

Besides this weaker initial impetus, a number of constraints is hindering economic expansion. Some of them (such as the greater freedom of foreign trade and payments, under fixed exchange rates) are likely to promote growth, provided they do not come into conflict with others — for instance, with the increasing cost of labour, and of government. Chart 1 c shows that the cyclical downturn of 1964 did not prevent these costs from rising still further.

Other constraints are the result of supposed political necessities which often ignore the interplay of economic forces. This applies to certain policies in respect of income distribution; of the spread of public enterprise, and the size of private firms; of prices (house rents, charges for public services, interest rates); of labour mobility between different activities and areas.

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